PICARD ANGST

HY 2019

Outlook & Comment

A roller coaster ride

The recurring manic-depressive mood swings on the global financial markets over the past year may have made many investors dizzy and evoked memories of roller coaster rides.

Against the backdrop of a global economy in an actually robust condition, negative returns in virtually all asset classes at the end of last year gave us the impression that the overreaction to moderate signs of an economic slowdown were then unjustified. Accordingly, we were confident that there would be positive start to the year, despite our expectation of a more challenging investment environment in 2019. We were nevertheless surprised that this recovery would be marked by a shift from depression to an equally intense manic mood and would be accompanied by positive returns in around 90% of all asset classes.

Against the backdrop of a continued slowdown in the global economy, it is difficult to argue that this recovery, which for a short time even recorded new highs on the global stock markets, is underpinned by a proportional improvement in fundamental data, even if the central banks have made an impressive turnaround and abandoned the path of a gradual normalisation of monetary policy.

At mid-year, the return prospects for the asset classes is even more modest than at the beginning of the year. Therefore, the likelihood that the second half of 2019 could follow in the footsteps of the previous year is significant. Investors are therefore advised to buckle up tightly.

Dr. David-Michael Lincke
Head of Portfolio Management

Overview

Headwind in the global economy

Dr. David-Michael Lincke, Head of Portfolio Management

In brief

· The disappointing economic outlook continues unabated across the world, with little sign of that this trend will reverse in the near future.

· It is true that the US Federal Reserve has turned the tide and switched to a course of monetary easing; however, the historical track record of efforts made by monetary policy to avoid recessions does not inspire much confidence.

· The escalation of the trade conflict between the United States and China is turning into an endurance test for world trade. If an amicable settlement is not reached in the near future, it will have a significant negative impact on the growth of the global economy.

· The vulnerability of the global financial system and the fragile state of the world economy is underscored by collapsing inflation expectations.

· Despite expectations of falling key interest rates, the US dollar has remained strong to date. However, this is likely to change in the second half of the year.

Outlook

There are few indications that the economic outlook will change soon. In particular, it is becoming apparent that the United States can no longer escape the downturn in the rest of the world. Taking historical track record as a yardstick, the central banks‘ shift to a course of easing could be too late. Collapsing inflation expectations underscore the recessionary trend, and the escalation of trade disputes promises additional headwinds for world trade and the global economy.

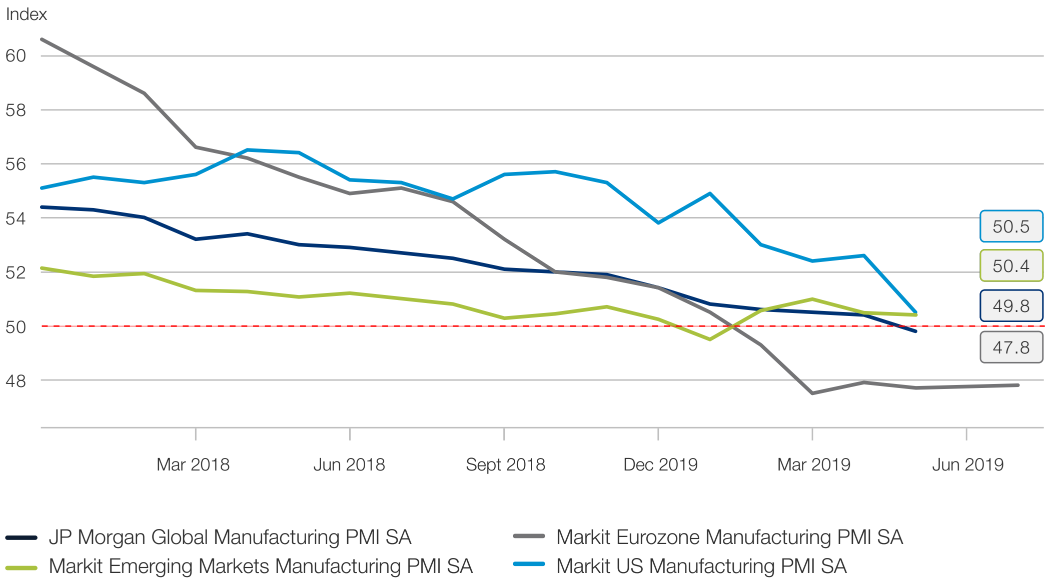
The disappointing development of the economic outlook continues unabated worldwide

As expected, the severe correction on the financial markets at the end of the previous year turned out to be an exaggeration. Widespread fears of recession were at least premature. However, the rapid recovery, especially on the stock markets, was not accompanied by a brightening of the economic outlook.

On the contrary, the weakening trend in leading economic indicators such as the Purchasing Managers' Indices for the manufacturing and service sectors, which had already been observed over the entire previous year, continued unabated in the first half of the year across the globe (see Fig. 1). The signs for the Eurozone in particular are now pointing to contraction. In China, too, the Purchasing Managers' Index has fallen below the expansion threshold of 50 and is weighing on the growth prospects of the emerging markets.

Fig. 1

The weakening trend in leading economic indicators has continued unabated throughout the world



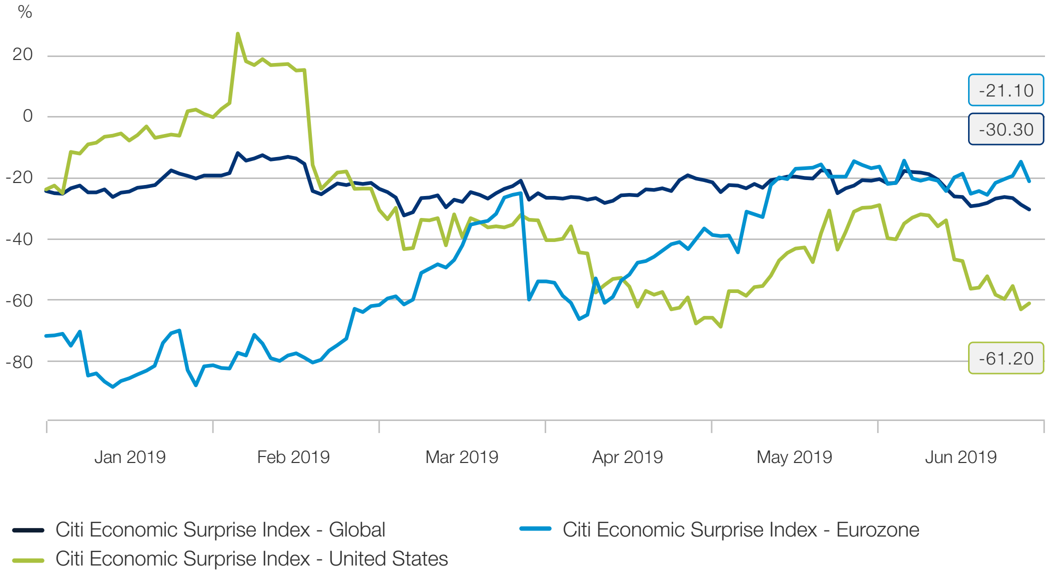
Source: Bloomberg LP, 2019

Even the United States, which has long held its ground as the spearhead of growth in the OECD region, is showing increasing signs of fatigue. For example, Citi's Economic Surprise Indexes illustrate that economic figures have been lagging particularly far behind market expectations since the beginning of the year (see Fig. 2). In the rest of the world, however, economic optimism has already largely evaporated.

Nevertheless, estimates of global economic growth in the current year have so far remained surprisingly robust. Despite a downward revision of expectations in recent months, the International Monetary Fund still expects an expansion of 3.3%. By contrast, the World Bank has reduced its forecast more dramatically to 3.7%.

Fig. 2

US economic data in particular lag well behind expectations



Source: Bloomberg LP, 2019

There are few arguments for an imminent turnaround. In the United States, for example, the fiscal stimulus from last year's tax reform has been exhausted. Hopes of a broad-based investment boost from companies have not materialised. Although full employment on the labour market is fundamentally positive, it also means that there is no reason to expect a continued spurt in exceptional employment growth. Due to the combination of demographic factors and sustained declining productivity growth, future real growth rates of barely more than 1% p.a. can be expected for the United States.

It should also be borne in mind that, in the case of the United States, this is now the longest economic expansion in the post-war period. From a statistical point of view, a recession is therefore becoming more and more likely. Over the past few weeks, various regional and sector-specific economic indicators as well as the inversion of sections of the yield curve have been providing early warning signals in this respect.

Europe is now suffering from political paralysis and confrontation. The substantial gains made by populist and right-wing parties in the European elections will not be conducive to an urgently-needed agreement on fiscal stimulus measures to replace monetary policy measures whose effectiveness has been depleted. France is in the process of gambling away hard-earned fiscal leeway to appease the Gilets Jaunes protest movement and the budget conflict between Italy and Brussels continues to escalate. However, the greatest downward economic potential is still presented by Britain's unregulated withdrawal from the European Union by – a scenario that can be ruled out less and less in view of the never-ending political scramble over the withdrawal modalities.

The emerging economies are finding it increasingly difficult to fulfil their intended role as the growth engine of the global economy. The extensive fiscal and monetary stimulus measures introduced by China over the past year have had only a very limited impact. It is questionable whether they will be sufficient to stabilise the growth path of the Chinese economy above the 6% mark, especially as the escalation of the trade conflict with the United States is increasingly producing headwinds. In general, the threat to world trade represents the greatest growth risk for export-driven emerging markets.

Can the dramatic turnaround in monetary policy change course for the economy?

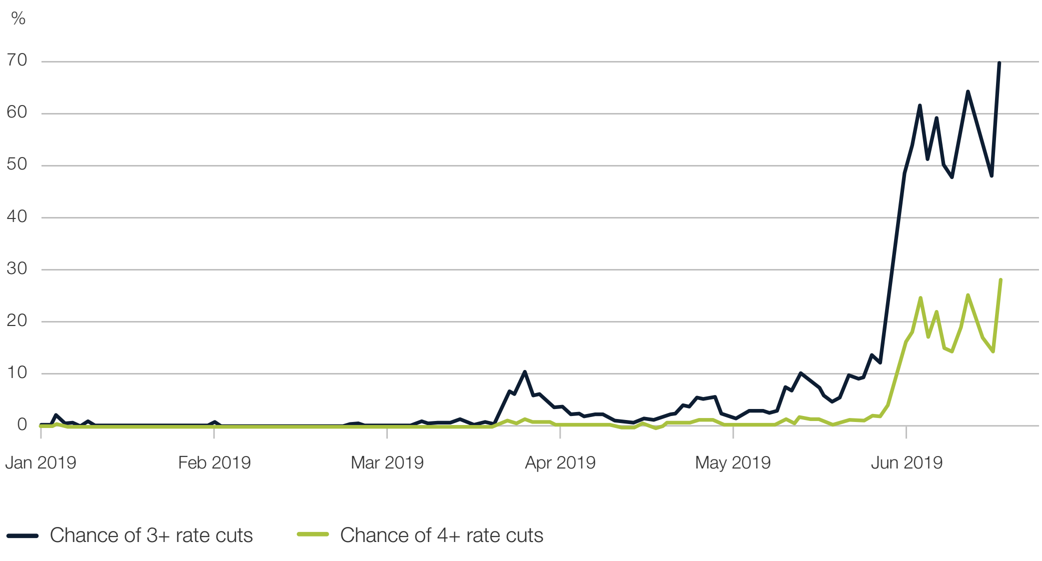
The trend reversal on the financial markets in the first half of the year was supported not least by a turnaround in monetary policy in the OECD region. At the beginning of the year, it could still be assumed that the flood of liquidity from the central banks' printing presses, which over the past decade has helped to raise the valuations of risky asset classes to ever higher, sometimes dizzying levels, would definitely pave the way for a recession. Since then, however, the picture has changed dramatically and there is no longer any talk of a normalisation of monetary policy.

In December, the US Federal Reserve not only announced that it intended to raise key interest rates at least twice or three times in 2019, it also announced that it would continue to gradually dismantle its inflated CB balance sheet. However, shocked by the deterioration in the economic outlook, these plans were shelved as early as January and a ‚wait-and-see' position was adopted. This was followed by the declaration of an end to interest rate hikes and the decision to stop the further reduction of the balance sheet as early as September 2019.

However, the market believes that the central bank is still falling short of the necessary measures. Hence the Fed Funds Futures market is highly likely to see more than three rate cuts for the remainder of the year, and even a fourth cut has not been ruled out (see Fig. 3).

Fig. 3

Development of expectations for key interest rate changes by the US Federal Reserve on the basis of the Fed Funds Futures Market



Source: Bloomberg LP, 2019

Against this backdrop, the question arises as to whether it is not already too late for the Fed to turn the tide and successfully avert a recession. The historical track record is not very encouraging. With the exception of 1967 and 1996, every interest rate cut that followed a cycle of rising interest rates inevitably led to a recession. In addition, with a cushion of only 250 basis points, there is considerably less ammunition available this time than in previous economic downturns, when the central bank felt compelled to lower key interest rates by an average of 375 basis points.

The European Central Bank‘s (ECB) options are even more limited in this regard, as it has postponed a normalisation of monetary policy until today. Nevertheless, the ECB not only recently ruled out raising interest rate before mid-2020, but even considered further interest rate cuts and flirted with resuming the QE programmes that were only discontinued at the end of 2018. The effectiveness of such steps are doubtful, however. On the one hand, this will put further pressure on the troubled European banking system, and on the other, the universe of eligible investments for the ECB‘s purchase programmes has largely run dry. In view of the lack of impact of European monetary policy, the credibility of ECB President Mario Draghi Kratzer has also been damaged, especially as his replacement is due this year.

1.3 Macroeconomics Trends

The escalation of the trade conflict between the United States and China is turning into an endurance test for world trade.

The hope for a speedy and amicable settlement of tensions between the United States and China regarding bilateral trade relations was also a potent driver of the financial market recovery in the first half of the year. It is hardly surprising, then, that this ended abruptly in May when the talks collapsed.

It is certainly true that it was primarily the trade deficit with China which the Trump administration initially took exception to. It should not be forgotten, however, that the conflict has a much wider dimension and meaning. Ultimately, the United States is concerned with keeping an emerging competitor for global economic and military supremacy in check. This explains its increasing focus on the technology transfer forced by China, the danger posed by China‘s monitoring of foreign companies and President Xi‘s ‚Made in China 2025‘ plan, which directly threatens the USA‘s technological dominance. The sanctions against the Huawei technology group should also be viewed in this context.

Although there is still a chance of de-escalation over the coming months, the increase in tariffs and their extension to other categories of goods and the retaliatory measures taken and considered by China will not only dampen the growth prospects of the two countries, but of the world economy as a whole. Even conservative estimates assume that this will reduce global economic growth by 0.5% by the end of 2020.

For the American economy alone, the consequences of continued escalation in the form of an extension of customs duties to all Chinese imports are much more dramatic. It is estimated that US gross domestic product would be 0.75% to 1% lower and that credit spreads in the high-yield sector could widen from below 400 basis points to over 700 basis points.

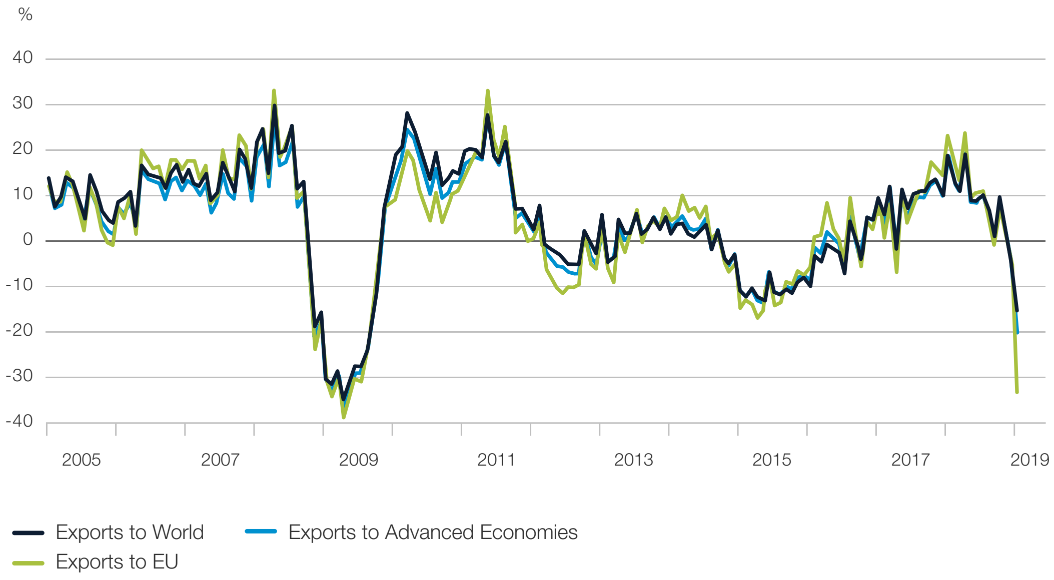
The global uncertainty triggered by the United States‘ new confrontational trade policy has already been reflected in the development of world trade. Trading volumes have been declining since the middle of the previous year – a trend that has accelerated further in recent months (see Fig. 4).

In response to the tariffs levied against China, a reconfiguration of global value chains is already emerging. Vietnam in particular appears to be profiting from the withdrawal of production capacities from China. In addition, Taiwan, Chile, Malaysia and Argentina are enjoying an increase in direct foreign investment.

There is also the danger that the next step in the escalation will be for the US administration to extend its confrontational trade policy to Europe, where the Americans cite the automobile sector as a particular thorn in their side.

Fig. 4

Rate of change in the volume of world trade year-on-year



Source: BMO Capital Markets, Macrobond, 2019

1.4 Macroeconomic trends

Collapsing inflation expectations underscore the vulnerability of the global financial system

Another motivation for monetary policy to throw all normalisation efforts out of the window could be the development of inflation expectations. After a temporary recovery over the first quarter, these have collapsed dramatically in recent weeks. For example, the break-even inflation rate for German government bonds fell to its lowest level since 2016, while the break-even rate for ten-year US Treasuries recorded a multi-year low of 1.6% (see Fig. 5).

One exception is the UK, where inflation expectations remain close to 3.5%. However, this is probably largely due to concerns about the inflationary consequences of a no-deal Brexit looming on the horizon.

The sharp correction in the oil price in May is also not a sufficient explanation. On the contrary, it seems that, in combination with the trade conflict, the US Federal Reserve's efforts at normalisation are threatening to suffocate the world economy. This underscores the vulnerability of the global financial system with its high level of indebtedness caused by only a moderate increase in funding costs and a stronger US dollar.

However, proclaiming the death of inflation, as the magazine Bloomberg Businessweek did in a cover story in April, may turn out to be premature, if not a contrary indicator over the longer term. The zeitgeist is changing and seems to be going in an inflationary direction. Warnings about over-indebtedness and budget deficits as well as warnings about more austerity have largely fallen silent. In return, radical theories such as „Modern Monetary Theory", which question the established separation of monetary and fiscal policy, have suddenly become socially acceptable; they not only find a platform in leading press outlets, but have even become the subject of parliamentary debates. The days of disinflation and deflation that lasted since the early 1980s may therefore be numbered and could herald a regime that in some respects is more reminiscent of the inflation dynamics of the 1960s and 1970s.

Taking a short-term perspective, it should also not be forgotten that the looming further escalation of the trade war will also have an inflationary effect.

Fig. 5

Collapse of inflation expectations after temporary recovery in the first quarter

Source: Bloomberg LP, 2019

1.5 Macroeconomic Trends

Unexpectedly strong dollar while EM currencies remain weak

After a year marked by the continued strength of the US dollar – not just against the currencies of most developed countries, but also still significantly stronger against the developed countries – there were signs for 2019 that the dollar's high would come to an end. In particular, the prospect of a gradual normalisation of key interest rates in the Eurozone supported expectations of a convergence of interest rate differentials.

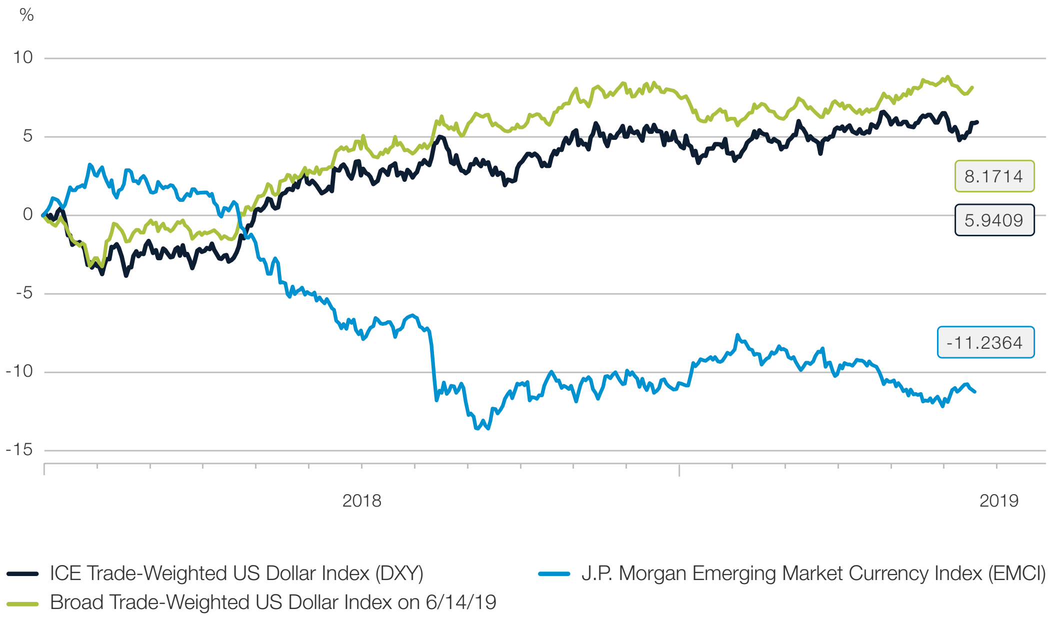
Since then, a reduction in the EURUSD interest rate differential has actually moved closer, albeit from a different direction than expected as a result of the turnaround in U.S. monetary policy. Nevertheless, the US dollar continued to stay strong (see Fig. 6).

One driving factor for this could be the shortage of dollar funding due to a reduction in the dollar supply from currency hedging transactions by investors outside the dollar zone. For years now, they have been suffering from a steady rise in hedging costs, which have now exceeded the threshold of 3% per annum for the Euro, the Japanese yen and the Swiss franc. Conversely, this means that, after cost deductions, investments in dollar-denominated bonds are now producing significant negative yields, which is increasingly prompting such investors to refrain from hedging currency risk (see Fig. 7).

Nevertheless, we expect the US dollar to weaken gradually in the second half of the year, given the scale of the expected interest rate cuts, which the ECB and the Swiss National Bank will not be able to keep pace with given the lack of room for manoeuvre.

Fig. 6

Distinct divergences on the FX markets as a result of US monetary policy: Broad and narrow trade-weighted US Dollar vs. emerging market currencies



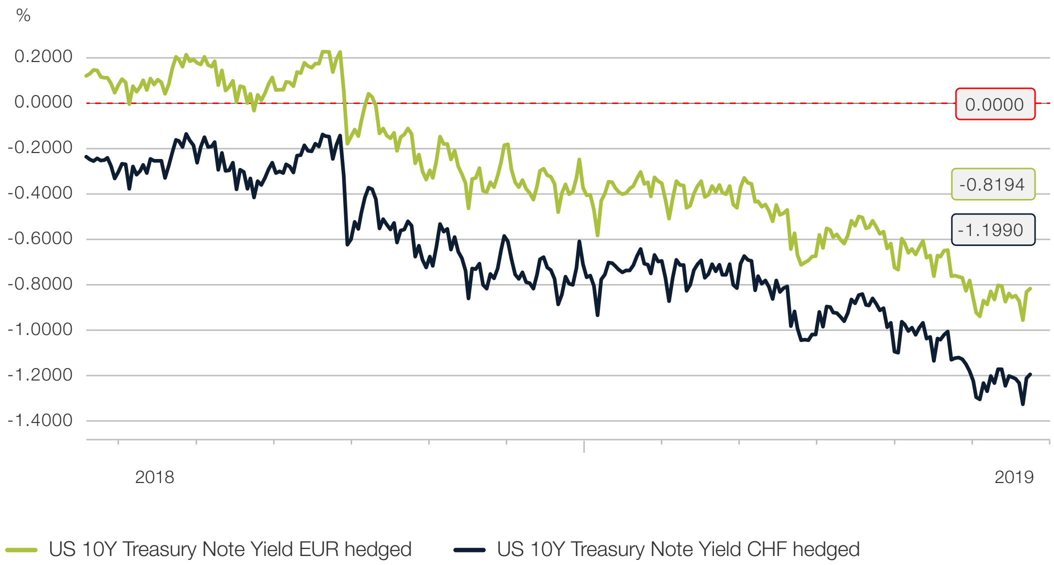
Source: Bloomberg LP, 2018

On average, the currencies of the emerging markets have not lost further ground against the US dollar in the current year, but they have not managed to recover either. This is because many emerging market economies continue to be burdened by declining capital inflows.

The escalation of the trade conflict has also left its mark on the FX market. In addition to obvious victims such as the Chinese yuan, AUDJPY is a currency pair that is even better suited as an indicator for the assessment of the currency market for the further development of the conflict. The Australian economy is particularly exposed to China due to its commodity focus and geographical location, while the Japanese currency has always been an effective barometer of risk aversion in the global capital markets due to its defensive character. This indicator does not yet provide any signs of an all-clear.

Fig. 7

Ten-year US government bonds with currency hedges in Euro and Swiss francs produce declining yields



Source: Bloomberg LP, 2019

Your contact

Dr. David-Michael Lincke

Head of Portfolio Management
E-mail: david-michael.lincke@picardangst.com
T +41 55 290 55 55

Selectivity opens up new opportunities

Dr. David-Michael Lincke, Head of Portfolio Management

In brief

· Global equity markets are still ignoring the gathering clouds, but a slowing of earnings prospects worldwide and EM underperformance call for caution.

· Distinct valuation divergences between regions and countries call for selectivity from investors but also open up opportunities. In addition to emerging markets, the medium- and long-term return prospects are also attractive for parts of Europe.

· The underperformance of value stocks against growth stocks, which has now persisted for almost a decade, is puzzling; however, it suggests a buying opportunity in the medium term.

· The US stock market is threatening to become the victim of its own success: its high outperformance compared to the rest of the world comes with the downside of excessive valuations, which makes us keep our distance.

· Despite the many structural headwinds, the hurdle for positive surprises in European equities is low.

Outlook

The nonchalance with which the stock markets have so far shaken off the economic risks and climbed to new highs is astonishing. However, the gradual deterioration in economic indicators worldwide and the resulting deterioration in corporate earnings prospects suggest that this is not a sustainable development and that a more challenging second half of the year can be expected. As risk aversion increases, the pronounced valuation differences between regions and countries are likely to have a greater impact. This calls for selectivity on the part of investors. In the medium and long term, emerging markets in particular offer attractive return prospects – but Japan and parts of Europe also appear interesting. US equities, on the other hand, should be avoided. Not only are they extremely expensive to value, but the high weight of the technology sector also increases the risk. Europe, on the other hand, appears favourable, but has to contend with structural and political headwinds on various fronts. We therefore continue to advise against a bargain hunt in the banking sector, and a commitment to the badly–battered automobile manufacturers seems premature. On the other hand, buying opportunities are tempting in Great Britain if one is willing to accept the continuing uncertainty surrounding the coming Brexit.

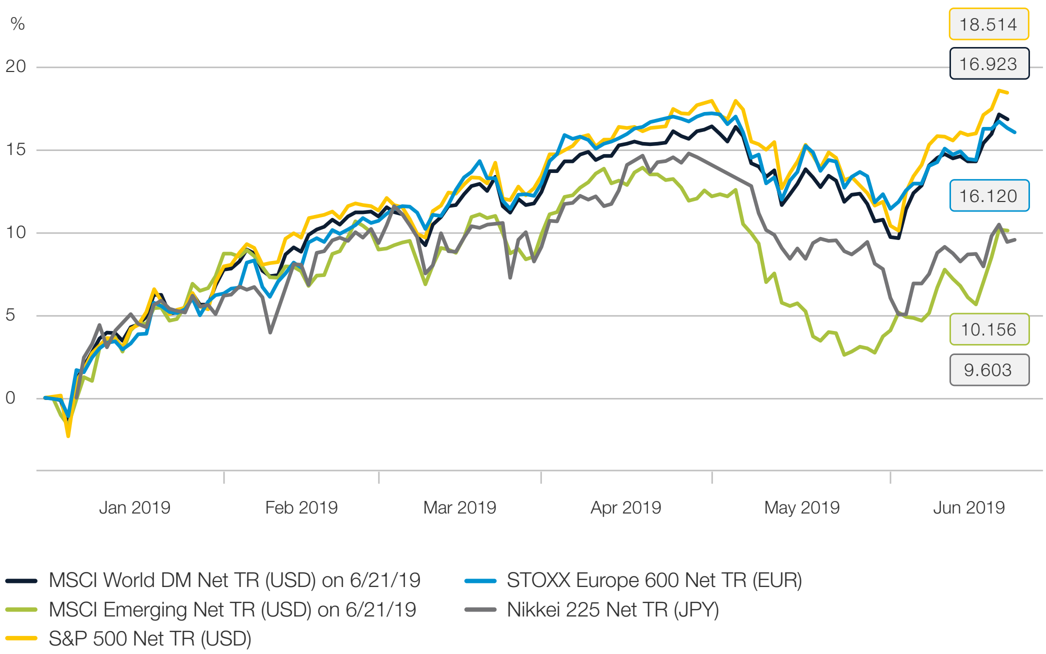
2.1 Equity Markets

Global equity markets are still ignoring the gathering clouds, but a slowing of earnings prospects worldwide and EM underperformance call for caution.

While excessive pessimism and fears of recession had caused the equity markets to suffer double-digit share price losses at the end of the previous year, the picture changed abruptly at the turn of the year. What initially looked like a purely technically driven counter-movement found additional underpinning with the US Federal Reserve's change of direction. However, the fact that at least the OECD equity markets have not only shaken off consistently weaker economic data but even the hardening trade conflict between the United States and China raises doubts that the new mid-year index highs will be sustainable (see Fig. 8).

Fig. 8

Development of selected equity markets in 2019



Time series indexed at 100 as at 31 December 2018. Source: Bloomberg LP, 2019

Even though the global average valuations are reasonable with a price-to-earnings ratio of around 15 and a dividend income of 2.9%, companies' earnings prospects are anything but promising. After a weak earnings period in the first quarter, particularly in the United States, corporate earnings growth will likely continue to cool off in the coming months. While the consensus among the analyst community had originally assumed 7%, expectations for the year as a whole have now shrunk to around 3%.

Companies' profit margins are also still under pressure. And it could get a lot worse. As semiconductors are playing an increasingly important role – not only in specialised technical equipment, but also in a wide range of products – sales in the semiconductor industry have not only become a reliable early indicator of economic growth and consumer demand, but also of the global trend in corporate earnings since the 1990s. The decline in semiconductor sales that has already been observed for a year has accelerated in recent months and, taking into account the lead time of a quarter, suggests that the stock markets are heading for a global earnings recession (see Fig. 9).

Fig. 9

Poor earnings prospects: In the past, semiconductor sales have proven to be a reliable early indicator for the development of global corporate profits

Semiconductor Sales, 3mma, YoY %
MSCI World Index, Trailing 12M EPS, rhs

Source: Nordea, Macrobond, 2019

This also explains the persistently subdued-to-negative investor sentiment regarding equities, which is reflected in sustained outflows from equity funds despite new highs. In the United States alone, these have totalled around USD 120 billion since the beginning of the year, the worst year since 2008 and 2016.

The companies themselves have jumped into the breach as buyers. Share buybacks fed by tax savings, repatriated capital and continued favourable financing conditions in the capital markets have set new volume records in the United States. A study by the Ned Davis Research postulates that without this support, the US stock market would be 19% lower than the S&P 500 index.

It is striking how clearly the equity markets of the emerging countries are lagging behind most of the developed equity markets this year (see Fig. 8). The emerging economies are much more exposed to the dynamics of world trade. It is therefore not surprising that this underperformance has continued to accentuate over the last two months since the collapse of the US-China negotiations. However, given the sustained higher growth rates in these parts of the world, it is surprising that the emerging markets have been experiencing a relative weakness in performance for almost ten years. Emerging market equities have now surrendered all the outperformance they had achieved since 2005 (see Fig. 10). Conversely, this has also accentuated the valuation advantage for companies in these regions, which raises medium- and longer-term return expectations significantly above the OECD average (see below).

Fig. 10

Emerging markets vs. industrialised countries: cumulative outperformance since 2005 surrendered

Source: Bloomberg LP, 2019

2.2 Equity Markets

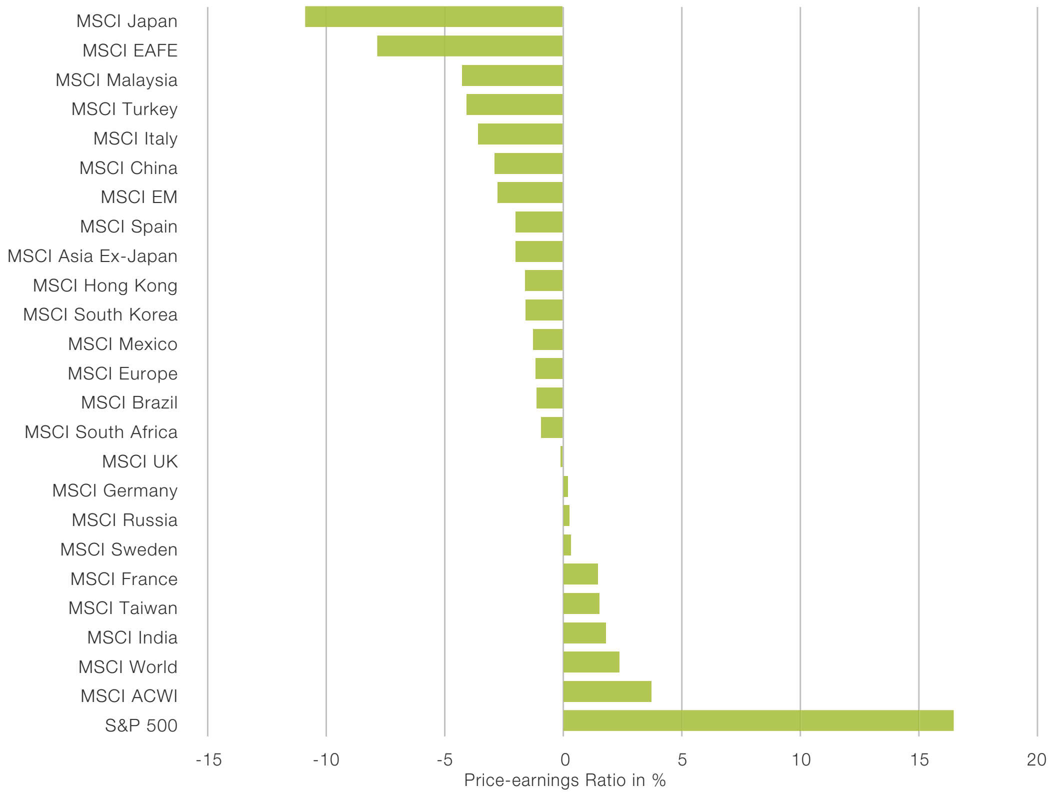
Distinct valuation divergences between regions and countries call for selectivity but also open up opportunities

If the earnings trend deteriorates, it can be expected that investors' risk aversion will increase. This normally leads to a sharpened awareness of valuations, which is why we expect an increasing dispersion of returns between individual regions and countries in the further course of the year.

Taking a valuation yardstick such as the cyclically-adjusted price-to-earnings ratio (commonly referred to as the Shiller P/E ratio) as a basis – which has proven its worth with regard to its forecasting power over longer time horizons – a picture emerges of an unusually high spread in valuations, not only between industrialised and emerging countries but also within the block of OECD countries. This becomes particularly clear when analysing the differences between the valuations of the individual markets and their long-term historical median (see Fig. 11).

Fig. 11

Extreme overvaluation in the United States, but enticing bargains in emerging markets and parts of Europe



Distance of the current cyclically adjusted P/E (CAPE) from the historical median.

Source: Research Affiliates, Bloomberg LP, 2019

From this perspective, Japan proves to be our favourite. Even though the economy is suffering from a slowdown of exports, equity valuations not only remain attractive on a relative basis, but also on an absolute basis. Of all the industrialised countries, Japanese equities are valued by most favourably by far. The low indebtedness of Japanese companies is another argument: On average, the ratio of net indebtedness to EBITDA is 1.48%, which is lower than in the other industrialised countries. In addition, the Japanese central bank continues to pursue an extremely loose monetary policy.

Europe disappointed again: the first full year of rising corporate profits in 2017 after six lean years now threatens be a flash in the pan. Although the region‘s economy has improved slightly and equity valuations are not overpriced overall, there are a range of economic and political challenges (Brexit, Italy, France), monetary support has dried up and any headroom as regards monetary policy (despite ECB representatives‘ assurances to the contrary) is largely depleted. This calls for an overall neutral attitude and selectivity.

If Italy were to adopt a sustainable solution to its debt situation, this would greatly enhance the attractiveness of the country‘s listed companies, especially as no other European country has such low company valuations. Other austerity-struck Southern European markets, such as Spain, also offer opportunities. France, on the other hand, is particularly to be avoided. Although the Swiss equities market is among those valued comparatively highly, it is nevertheless likely to perform better than the European average in the coming year given its defensive qualities.

After the sharp price losses they suffered over the past year, emerging market equities appear particularly attractive. Thanks to China and others, economic activity in the emerging markets is developing better than in the industrialised countries. The significant valuation discount compared with the developed equity markets also count in their favour; this now reflects a good portion of risks posed by trade conflicts, to which the emerging markets are particularly exposed due to their export-driven nature.

The currencies of the emerging markets have lost a lot of ground, but have been showing signs of bottoming out for some months now and are trading significantly below value. Prospectively, they are likely to benefit from the change in monetary policy in the United States, which will lead to a gradual weakening of the US dollar and remove incentives for capital flight.

In addition, many investors are still cautious when it comes to the prospects of the emerging markets as a whole. In our view, this should be seen as a counter-indicator that suggests upward potential.

The most important submarket and driver for the emerging markets is and remains China, in both a positive and negative sense. Much will depend on the success of China's recently intensified efforts to set reflation impulses with fiscal and monetary policy measures. However, other Asian markets such as Malaysia also appear attractive from a valuation point of view.

2.3 Equity markets

A buying opportunity for value stocks against growth stocks is in the offing in the medium term

One phenomenon that has shaped the overall recovery and economic expansion since the global financial crisis is the sustained worldwide underperformance of value stocks (value factor) against growth stocks (growth factor) (see Fig. 12). What is striking here is that this situation is largely limited to the segment of highly capitalised companies.

Fig. 12

The long-term underperformance of value stocks against growth stocks continues

Source: Bloomberg LP, 2019

A similar situation recently arose during the internet bubble around the turn of the millennium. Back then, there was a speculative mania in individual areas of the technology, media and telecoms sectors, which asset-focused investors had to sit out. At the same time, however, value stocks performed quite well in absolute terms. This time, however, value stocks continue to depreciate despite low valuations. The overall profit growth of these companies did not disappoint. Therefore, the segment‘s neglect cannot be attributed to the spread of value traps, which remain cheap for good reasons.

A mixture of different influencing factors is likely to have contributed to this marked divergence in the current cycle. The extent to which disruptive technologies and business models have transformed established industrial structures in the technology, tourism and transport sectors, but also in the retail trade, and contributed to a ‚winner takes all‘ dynamic in view of strong network effects, is obvious. The resulting concentration process has encouraged the rise of large monopolistic providers at the expense of established structures. The trend towards passivation and thus indexation of investments resulted in additional strengthening of the momentum and growth factor. Added to this was the relatively sluggish recovery of the real economy in the current expansion cycle compared with the stock market trend.

Although it is advisable for investors to weigh factors in the portfolio more highly when they are low-valued, valuation alone is not sufficient reason to anticipate a trend reversal. A number of conditions will probably have to be met, at least in part, before a sustained revival of the value factor can be expected on the equity markets. These include a stricter regulatory regime that does not shy away from breaking up monopolistic structures – such as those that have developed in the case of internet companies – as well as saturation of the trend towards investment passivation and thus stabilisation of the volume of actively managed investments, which traditionally have a value focus. A reduction in uncertainty regarding the economic outlook and an acceleration of the global economy would also be beneficial. But even a reset of the current cycle in the course of a recession could be suitable to bring about corresponding repricing of the risk premiums.

Against this backdrop, and given the extent to which the underperformance of the value factor has taken hold, we assume that their days are numbered and that investors are well advised not to take equities off the radar.

2.4 Equity Markets

US equities – Falling star with outstanding track record

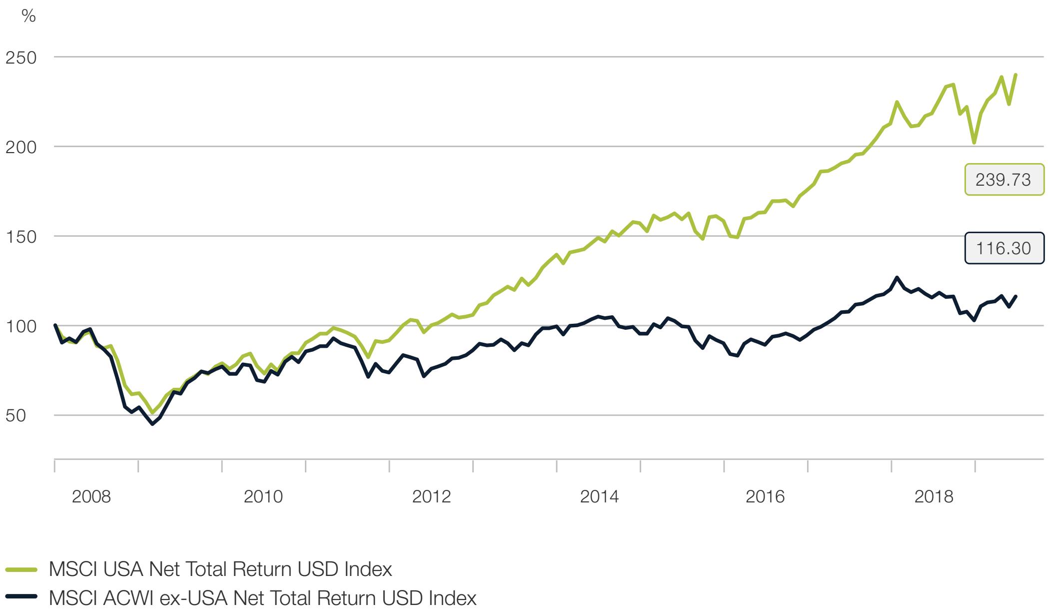
Over the last decade, the American stock market has left the rest of the world in the dust. While the S&P 500 and MSCI USA benchmarks have reached new highs, the rest of the world – measured by the MSCI ACWI ex-US Index – is in a sideways consolidation (see Fig. 13).

However, only half of the high performance was underpinned by rising corporate earnings, which is now reflected in an impressive valuation premium against the rest of the world and is weighing on the prospective return prospects (see. Fig. 11).

IIn the meantime, the one-off effects from the reform of corporate taxes, which catapulted profit growth to 23% in 2018, are a thing of the past. But even the profit growth expectations of a mere 7% for the current year have now shrunk to only 3%. This implies a recovery in the second half of the year, however. According to FactSet, US corporate profits fell by -0.5% in the first quarter. A significant gap has opened up between multinational groups and companies focused on the domestic market.

Fig. 13

Hardly any recovery for the rest of the world, while US equities scale new heights



Source: Bloomberg LP, 2019

While the latter recorded moderate profit and sales growth, the former saw profits fall by more than 12%, with stagnating sales. In addition to the stronger US dollar compared to the same period last year, this also likely to be a consequence of the trade war. An earnings recession with two consecutive quarters of falling profits remains a real scenario for the US equity market.

The US market appears all the less attractive if one considers its high valuation and its disproportionately strong focus on cyclical industries. This cyclical orientation is more pronounced than in any other major market, with the exception of Japan, and this market is more exposed than emerging markets to cyclical sectors for the first time in its history.

Technology stocks – which almost twenty years after the internet bubble have become the driving force behind the US stock market again – are a particular cause for concern among cyclical stocks. Their share of market capitalisation now stands at over 25% – a level that was only crossed once before for a short time in 2000, before the speculative bubble burst. The dependence of the broad equities market on the fate of the technology sector is thus currently higher than ever before.

For a long time, investors have ignored the potential risks of the trade war on technology stocks. This has now come back to haunt them. The fact that the US government has blacklisted Chinese companies such as Huawei is raising the spectre of a new technological Cold War and illustrates how susceptible companies in this sector are to sudden restrictions. Due to the close interdependence of the value chains, the consequences can be felt throughout the entire global value chain. US semiconductor stocks have fallen 15% from their peak and are now back at the same level they were a year ago.

The risk represented by the technology sector for the broad equity market is by no means limited to a potential clouding of the course of business. The high sector concentration is particularly the result of the strong positive network effects that characterise many of the business models; the positive externalities promote a winner-takes-all dynamic whose natural end result is the establishment of monopolies. Although the interpretation of antitrust law in the United States has become much more cautious since the Reagan era, the fact that the reach of advertising and social media platforms has now entered the political sphere and even influenced the outcome of elections has provoked a potentially far-reaching political reaction. Even if the destruction of monopolistic structures were to be halted, alone the introduction and enforcement of more stringent regulation to protect private data sovereignty and privacy could severely affect the business models of the technology giants. The US Department of Justice's recent announcement of an antitrust investigation into Google's parent company Alphabet underscores the seriousness of this risk.

With regard to portfolio positioning, this indicates a significant underweighting, if not elimination, of the exposure to US equities. The extent of the valuation divergences also makes currency-neutral, market-neutral long-short combinations appear attractive, especially with regard to Japan, the emerging markets and Europe.

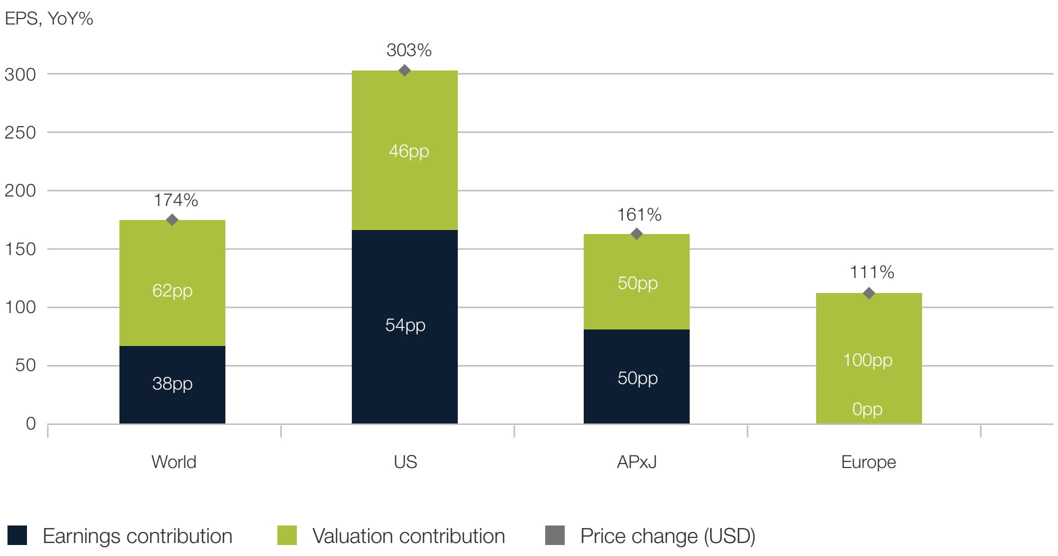
2.5 Equity Markets

Low hurdle for positive surprises in European equities

The fact that European equities have posted by far the weakest performance among the world's major regions over the past decade is owed not least to the fact that corporate earnings have stagnated overall during this period (see Fig. 14).

Fig. 14

With the exception of Europe, the previous decade's stock market performance of the was driven to a large extent by corporate earnings growth



Source: Worldscope, Datastream, Goldman Sachs Global Investment Research, 2019

After repeated disappointments, and in the face of constant headwinds from political and structural factors, expectations of the European stock market have been relativized over the past few years. Valuations are correspondingly low, especially in the peripheral states of the European Union. Also, unlike in the United States, the danger of a profit recession does not appear acute. The hurdle for positive surprises in European equities is therefore low.

However, the prices of defensive stocks such as utilities, pharmaceuticals and consumer staples, which are currently very attractive to investors in view of the shaky economic outlook, are already reflecting respectable premiums.

From a valuation point of view, the European automotive sector seems particularly interesting. However, it is still suffering from a sharp drop in sales. Patience is likely to be required here, as a sustained recovery in share prices in this area requires a brightening of the economic outlook.

Most European banks are valued even lower and only traded at a fraction of their book value (see Fig. 15). They have sat out the recovery of the broad stock market since the beginning of the year. The extremely low valuations show that market participants have lost faith in the reported balance sheet value. Paradoxically, it is not least the continuing extremely loose monetary policy, which is actually intended to support the European economy, that is depressing the profitability of the banks. The failure of high-flown merger plans, such as those between Deutsche Bank and Commerzbank, as well as similar thought experiments in the French and Italian banking systems, makes it clear that the problems cannot be solved by simply concentrating and forming larger units. Instead, long-deferred deep cuts in the form of rigorous recapitalisations and the painful realisation of protracted losses will be needed to recover the banking system. For these reasons, we advise following the siren call of low valuations in this case.

Fig. 15

The ailing European banking sector still awaits a solution

Source: Bloomberg LP, 2019

Although or precisely because they are shaken by the prevailing uncertainty regarding the shape of the upcoming Brexit, British equities appear attractively valued. This is owed not least to the fact that companies in the leading FTSE 100 index generate most of their turnover outside their homeland. A favourable currency, low valuations and the fact that the economy has so far managed to weather the political storms are all reasons for an overweight in British equities.

Factor premiums as a source of return

Marco Tinnirello, Head of Systematic Strategies

Academic research has identified and documented various factors that can be used to achieve a positive return and whose return potential is not justified by additional risks

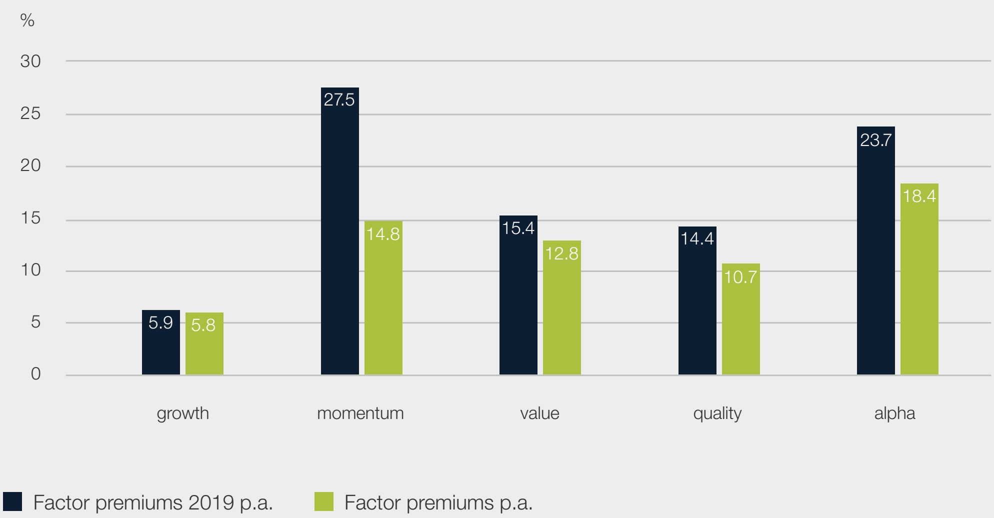
Individual portfolios constructed on the basis of these factors are already successfully implemented in the long term, such as value strategies (value factors), small-cap strategies (size factors) or quality strategies (quality factors). Although these types of factor strategies have the potential for an excess return over time, the premiums fluctuate significantly in the short term and phases of lower returns may occur.

Thanks to the low correlation of different factor groups, a combination of different factors (value, quality, momentum, growth) can counter this problem and a robust and stable approach can be developed.

In many cases, factor returns are justified by certain anomalies arising from information processing (behavioural finance, over- or underreaction to information).

The momentum criteria and the quality criteria achieved the highest premiums globally. Shares with a clearly positive/negative price development in the past also achieved a clearly positive/negative price development in the period under review. Equities with above-average qualitative characteristics also achieved above-average performance.

Factor premiums in the long term and 2019



Source: Factset – Picard Angst

Switzerland also showed a strong development of momentum factors and a correspondingly high premium in the first half of the year. After a partial decoupling of the price development from fundamental criteria in the first quarter, the value criteria in particular made a high contribution in the second quarter.

In the first half of the year, a positive premium was observed in all factor groups (value, quality, momentum and growth). The combination of the factors in a multi-factor approach achieved a correspondingly high premium, which even exceeded the long-term average.

With our systematic investment strategies, we offer investors access to equity investments which, in addition to the classic market return, integrate other return drivers and thus represent an alternative to passive investment strategies while still being implemented in a transparent and rule-based manner.

This enables investors to participate in sources of returns that cannot be tapped using purely passive approaches. With our systematic approach, we take account of a large number of quantitative factors, which efficiently evaluate fundamental data, price data and analyst estimates and incorporate them into portfolio construction. The strategies are theoretically sound, comprehensively tested and implemented in a disciplined manner.

Your contact

Christopher Kumpas

CEO Picard Angst MEA
E-mail: christopher.kumpas@picardangst.com
T +971 (0)4 3785 111

Time again to increase duration risks

Dr. David-Michael Lincke, Head of Portfolio Management

In brief

- The bond markets paint a gloomy picture of the economic outlook for the global economy. Not only have interest rates fallen dramatically worldwide at the long end, the inversion of the US yield curve also signals the danger of a recession.
- The global market value of negative interest-bearing bonds has reached a new record high.
- Against this backdrop, investors are advised to raise duration risks in the portfolio again.
- High economic sensitivity and the gradual deterioration in the quality of the investment universe have caused us to keep our distance from corporate bonds, while emerging market bonds are on the upswing again, attracting significantly higher yields than government bonds from the OECD region.

Outlook

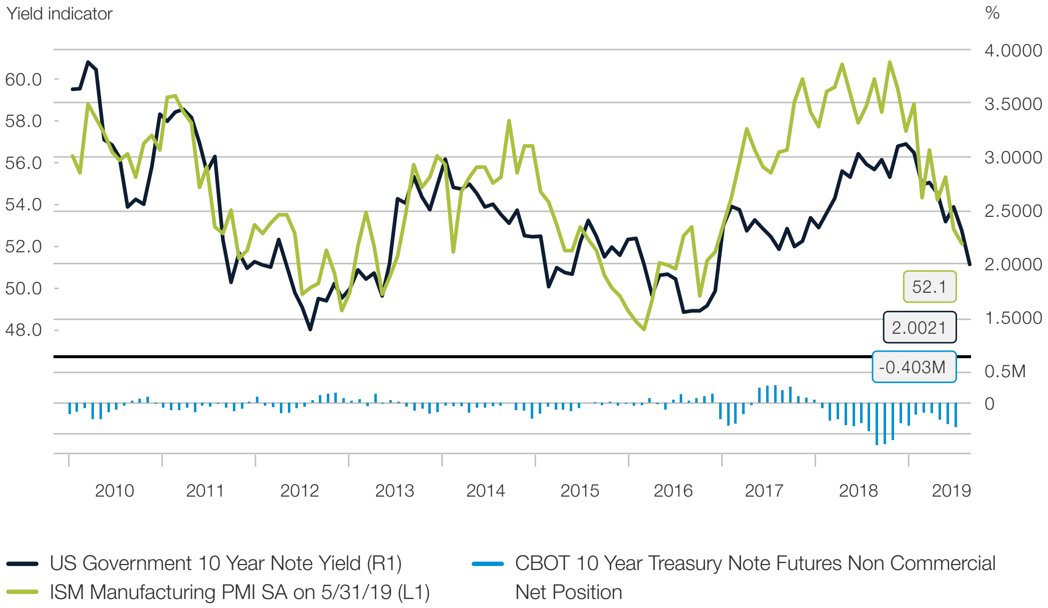
Although quotations for government bonds have already risen dramatically since the beginning of the year and have massively increased the proportion of negative interest-bearing bonds (particularly in Europe), the price of government bonds has risen sharply since the beginning of the year. Should the anticipated slowdown in the global economy continue, however, there is still considerable further price potential, especially for US government bonds. We therefore recommend investors to increase the duration risks in the portfolio and to reduce money market exposures and variable-rate investments in view of the coming cuts in key interest rates. In particular, emerging market bonds offer opportunities to optimise portfolio returns, not only attracting higher declines in yields but also promising additional potential in view of significantly undervalued currencies. By contrast, we remain reluctant to issue corporate bonds, despite an encouraging performance so far this year. The quality of the asset class has continued to deteriorate and cyclical vulnerability has increased.

The bond markets paint a gloomy picture of the economic outlook for the global economy

The much-cited turnaround in interest rates, which ten-year US government bonds at times saw flirting with yields of more than 3%, proved to be a short interlude. Since the beginning of the year, yields on long-dated bonds have travelled in only one direction, namely south. With the decline in leading indicators such as the ISM Manufacturing PMI, the expectations gap has also closed, and the signs point in unison to a slowdown in growth (see Fig. 16).

Fig. 16

US government bonds signal economic pessimism, which is now being confirmed by leading economic indicators



Source: Bloomberg LP, 2019

It is also fitting that the compression of inflation premiums continued after a brief recovery in the first quarter, which was primarily due to rising energy prices. In both Europe and the United States, inflation expectations have fallen to new lows and are now well below current spot inflation (see also chapter „Macroeconomic Trends").

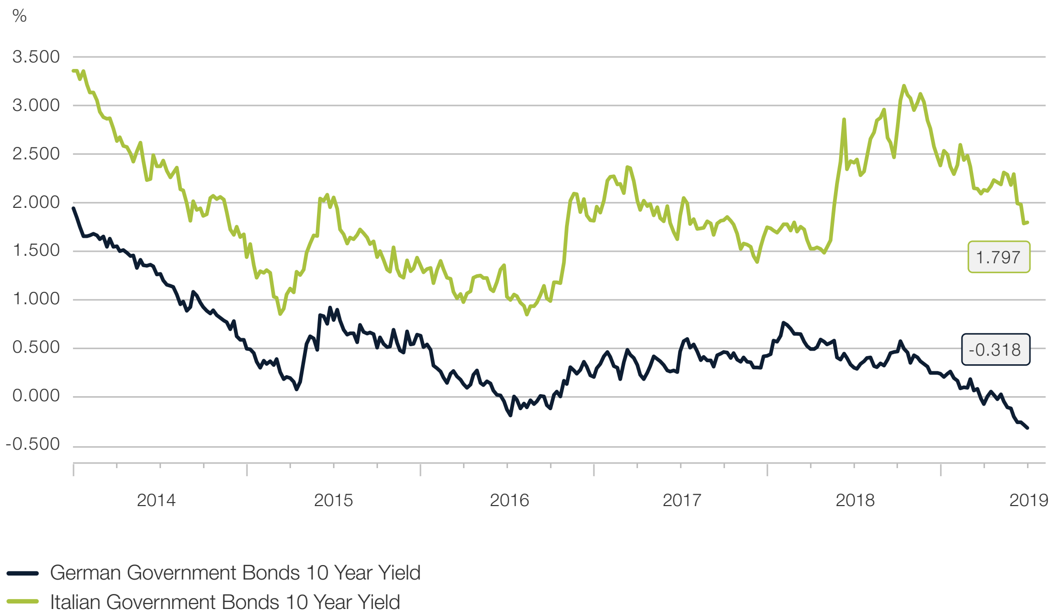
Nevertheless, the positioning data of the futures exchanges indicate that, in view of the recent rise in net short positions, a good portion of investors have not yet come to terms with the economic implications of falling interest rates at the long end (see Fig. 16).

However, factors that could drive interest are increasingly weakening. The gradual dismantling of the inflated US central bank balance sheet, which throws an additional USD 50 bn in bonds onto the market every month, will come to an end from September. What remains is the massive increase in the financing requirements of US Treasury. Last year's tax reform has left deep holes in the treasury and the budget deficit threatens to break through the trillion mark this year.

The situation in Europe is even more dramatic. The yields on German government bonds have fallen to an all-time low of -0.32%. In Switzerland, even thirty-year-old Confederation bonds no longer have any positive earnings expectations. Even a problem child like Italy, which is in a bitter conflict with the EU Commission over compliance with budget deficit limits, is enjoying falling interest rates at the long end (see Fig. 17). The market pressure on Italy has thus receded. As already postulated in our Outlook for the year, this development underscores the fact that a sustainable solution to the problem of over-indebtedness is not only far from being found in Italy, but an escalation into an acute crisis, which will once again focus on convertibility risks and the continued existence of the Euro, is also just as unlikely in the near future.

Fig. 17

New lows for the yield to maturity on German government bonds, while interest rates in Italy have also fallen significantly despite the budget crisis



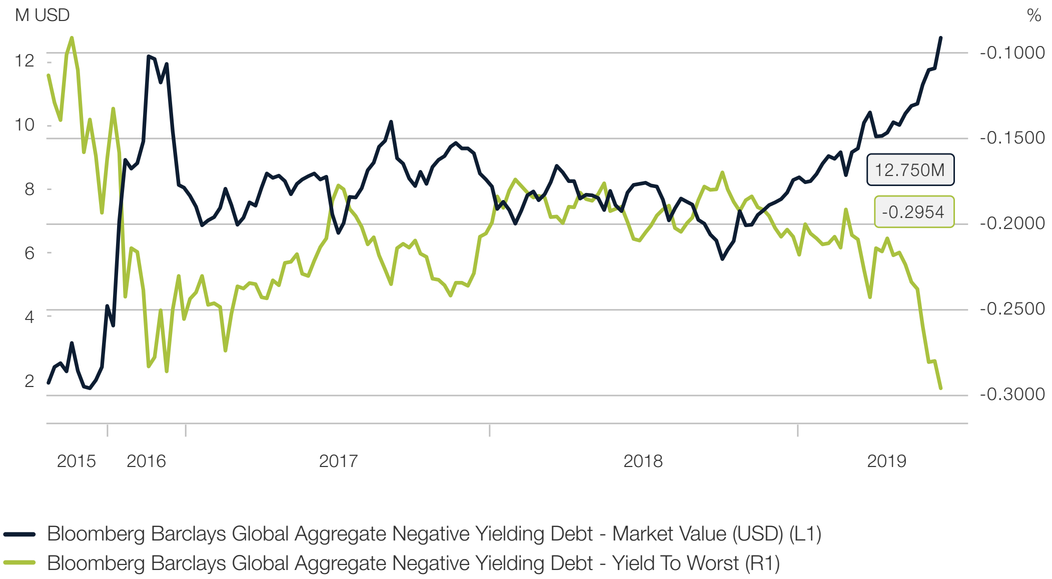
Source: Bloomberg LP, 2019

This means that interest-rate dampening structural factors have regained the upper hand at the long end of the yield curves, as long-term real interest rates are closely linked to the potential growth of an economy. Given the steady decline in potential growth for developed economies over the past decade, it is likely that the real interest equilibrium rates will remain close to their current low levels, even if a recession is avoided. The structural factors that contributed to this include the accelerated demographic change, the high indebtedness of both public and private budgets and the resulting lack of propensity to consume and invest.

The dramatic nature of this development becomes particularly clear when one considers the development of the outstanding market value of bonds with negative yields to maturity (see Fig. 18). This has risen sharply since the beginning of the year and has reached a level of almost USD 13 bn, exceeding the peak of 2016. The weighted yield to maturity on these liabilities has also fallen to a new record low of -0.3%. This means that half of all outstanding European government bonds and 20% of the universe of European corporate bonds with investment grade ratings are now producing negative yields. The „Japanification“ of the rest of the world is in full swing.

Fig. 18

Global market value of negative interest-bearing bonds has risen to a new record high



Source: Bloomberg LP, 2019

Even more clearly than when using basis of falling declining yields alone, signals of scepticism regarding the longevity of economic expansion are revealed in an analysis of yield curves. These have flattened further for US Treasuries in the course of the year to date. Segments that cover more than 60% of the treasury curve have even inverted, including the noteworthy segment between three months and ten years (see Fig. 19). In the past, the inversion of the yield curve has proven to be a reliable harbinger of an economic downturn and has preceded the last seven US recessions. However, its use as a timing signal is limited. In the past, the period up to the actual onset of a recession has lasted from a few months to more than two years.

In order to benefit as an investor from this development, it makes sense to bet on a continuation of the yield curve's inversion trend, for example, by means of flattener structures on the segment between two and ten years.

Fig. 19

The inversion of the yield curve has proven to be an indicator of an imminent recession in the United States in the past.

Source: Bloomberg LP, 2019

3.2 Bonds, Money and Credit Markets

Investors are advised to increase duration risks in their portfolios again

While variable-rate exposures on a USD basis in floating rate notes or in the US money market were still the first choice at the beginning of the year in view of a tightening monetary policy, the picture changed dramatically with the turnaround in US central bank policy.

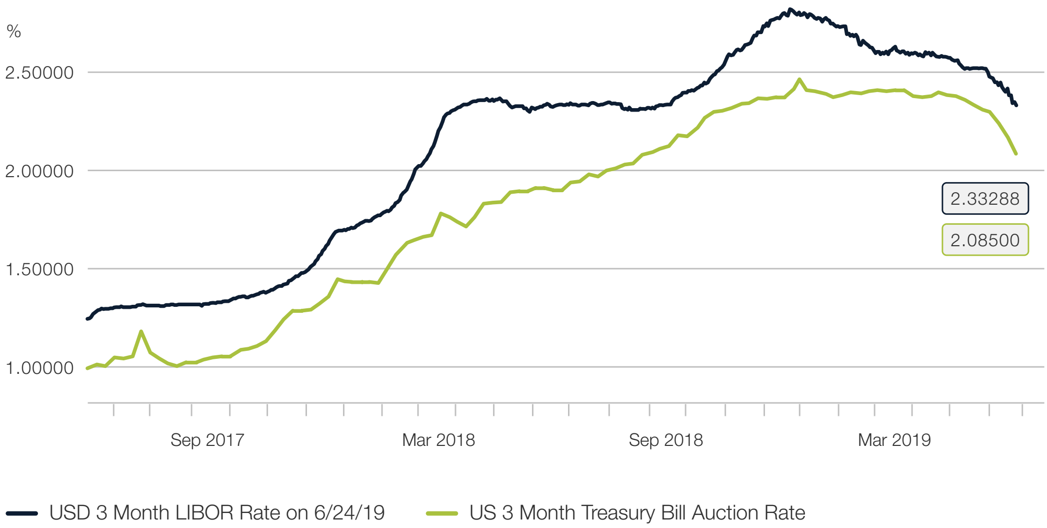
The money market has already responded to expectations of up to three rate cuts in the second half of the year. The yield on three-month US Treasury Bills is already 25 basis points below the lower threshold of the current key interest rate corridor of 2.25% to 2.50%. US dollar LIBOR shows a comparable trend.

In the rest of the world, too, efforts to normalise monetary policy have come to an end before they were even seriously attempted. The ECB has already announced further interest rate cuts and even the resumption of bond purchases.

Investors are therefore advised to increase the duration risks in their portfolios again and to give more weight to fixed-interest bonds with a long maturity. Should scenario of a recession materialise, there is then potential for a significant further fall in declining yields, especially on US bonds.

Fig. 20

The US dollar money market has already responded to the expectation of falling key interest rates



Source: Bloomberg LP, 2019

3.3 Bonds, Money and Credit Markets

Emerging market bonds on the rise again

In terms of yields, bonds issued by emerging countries are much more attractive than government bonds from the OECD region. This is because there are still declining yields of over 5% in both local currency and hard currency.

Factors that put emerging market bond markets under significant selling pressure last year have largely dissipated. This means that, against the backdrop of constantly rising interest rates in the United States and the associated appreciation pressure on the US dollar, the devaluation pressure on the EM-FX complex has come to an end. Incentives for capital flight and the resulting compulsion to pursue a restrictive monetary policy have diminished. However, the threat of a further escalation of the trade war is still a risk for the export-dependent emerging market economies.

As a result, emerging market bonds have already performed well in the first half of the year. According to the JP Morgan GBI-EM Diversified Index, they gained more than 8% in local currency terms in USD and even delivered 10% returns in hard currency terms on the basis of the JP Morgen EMBI Global Index (see Fig. 21).

In our Outlook, emerging market bonds in local currency appear particularly promising. Despite the recent recovery, emerging market currencies continue to trade well below their true value against the US dollar. They should continue to appreciate in the coming months thanks to favourable economic conditions. Economic growth in the emerging markets continues to be better than in the industrialised countries. The gap between the leading indicators of the emerging and industrialised countries remains wide.

However, hard-currency emerging market bonds are also still attractive, as the relative economic strength of emerging markets helps to narrow the yield spreads between these bonds and US government bonds.

According to the Institute of International Finance, emerging market bonds recorded inflows of USD 24 bn in April for the eighth consecutive month.

Fig. 21

The outlook for emerging market bonds has brightened significantly

Source: Bloomberg LP, 2019

3.4 Bonds, Money and Credit Markets

Credit markets: Latent but tame source of systemic risk, even in the short term

In the corporate bond markets, the turnaround in monetary policy – from tightening, to the sudden possibility of interest rate cuts – has pushed the risks of weaker growth into the shadows. As a result, the yield spreads between riskier bonds and relatively safe bond instruments have narrowed. Interest premiums for US investment grade bonds and US high-yield bonds against US government bonds have fallen steadily since the beginning of the year and only recently picked up again moderately in the wake of the trade talks' collapse. Spreads are thus well below the level they had reached in 2015/16, in an environment of similar uncertainty regarding the outlook for the global economy (see Fig. 22).

Nevertheless, it is becoming increasingly clear that the credit markets are probably the weakest link in the chain of global risk sources. There are a number of reasons for this:

Fig. 22

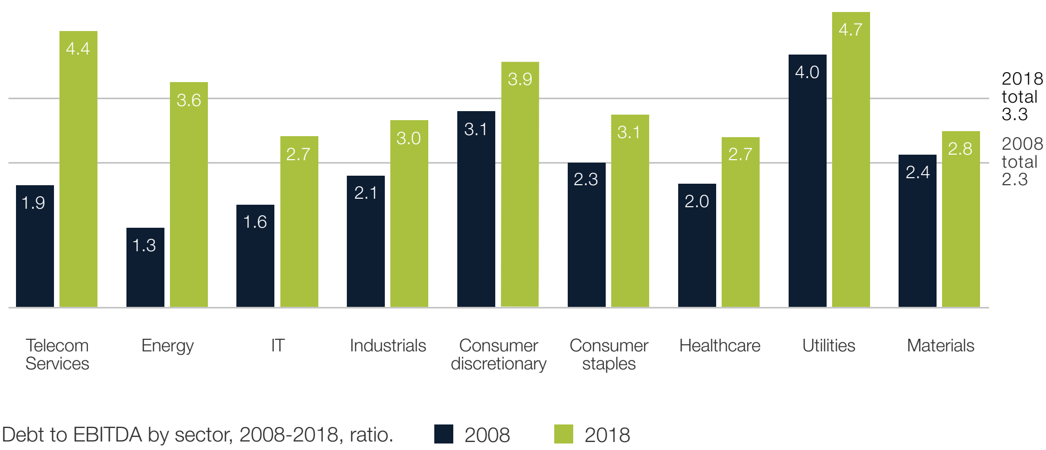
Credit spreads in investment grade and high yield sectors have shrunk since the beginning of the year

Source: Bloomberg LP, 2019

The era of cheap money and unlimited liquidity over the past decade, combined with a subdued economic environment that offered only limited organic growth opportunities, has given companies incentives to leverage their balance sheets to an unprecedented extent. The ratio of net corporate debt to earnings power (EBITDA) across all sectors is significantly and in some cases even dramatically higher than in 2008 when the global financial crisis broke out (see Fig. 23). In the weaker economic environment that is becoming apparent, there is a particular threat of a slowdown in sales growth, falling profits and pressure on profit margins. This will make the serviceability of these liabilities more difficult and will result in tightening credit spreads and, indirectly, rising default rates.

Fig. 23

Corporate debt ratio by sector in 2008 vs. 2018



Debt to EBITDA by sector, 2008-2018, ratio.

Source: McKinsey & Company, 2019

From an investor‘s perspective, the fact that the quality of the investment universe as a whole has gradually deteriorated over the past few years is also cause for concern. A study by Morgan Stanley concludes that if only the degree of indebtedness of companies were used as a criterion, 45% of all corporate bonds rated as investment grade would instead have to be classified as junk. In 2017, this share was only 30%; in 2011 it was only 8% of the universe. The proportion of low-quality bonds with a BBB rating has also risen massively over the last decade and, with more than 50% of the investment grade universe, is now higher than the sum of all bonds in the AAA-A rating band. In the event of an economic downturn, BBB bonds are particularly susceptible to downgrades, and generally suffer from particularly pronounced price losses in this case due to their falling out of the investment-grade universe.

The outlook for Europe is particularly bleak. Valuations on the European credit markets have improved over the past year. However, with the discontinuation of the ECB‘s CSPP corporate bond purchase programme, which has been an essential source of demand over the past two and a half years, buyers at the current spread level are likely to remain scarce. The high-yield sector in particular is suffering from the easing of the investment crisis. In addition, investment funds have already experienced strong outflows of between 7% and 8% of their funds in the past year – a trend that is likely to continue. Corporate bonds have an inherently asymmetrical yield profile to the detriment of investors, i.e. they are characterised by a higher downward than upward potential. This is all the more true at the end of this cycle, as the current historically low yields mean that investors will have to forgo many years of coupon income when a company is downgraded or financially restructured. For these reasons, we recommend that investors exercise restraint with regard to corporate bond exposures, particularly with regard to high-yield bonds and BBB bonds.

Your contact

Christopher Kumpas

CEO Picard Angst MEA
E-mail: christopher.kumpas@picardangst.com
T +971 (0)4 3785 111

Greatest upside potential for precious metals

Dr. David-Michael Lincke, Head of Portfolio Management

In brief

- The late-cyclical economic momentum gave the commodity markets a positive first half of the year with gains in all major commodity benchmarks.
- However, the risks for a continuation of the friendly trend are increasing. Not only have the prospects for the global economy deteriorated further, but the political dispute over the shape of world trade is also threatening to escalate further.
- Nevertheless, there are a number of arguments that continue to support a positive commodities year in 2019. That said, it is advisable to favour commodities facing supply-side bottlenecks or production constraints, as demand-driven commodities and sectors are likely to struggle.

Outlook

After a positive first half of the year on the commodity markets, uncertainty regarding the outlook for the rest of the year has increased significantly. Falling growth and inflation expectations raise questions about the longevity of the commodity cycle. However, bottlenecks in supply and production point to continued potential in agricultural commodities, especially cereals and raw sugar, as well as in the energy sector. In contrast, without an early settlement of the smouldering trade conflict and a brightening of the global economic outlook, base metals are likely to struggle. That said, in view of the turnaround in monetary policy and rising risk aversion on the financial markets, the greatest upside potential is to be found in precious metals.

Late-cyclical economic momentum gives raw material markets a positive first half of the year

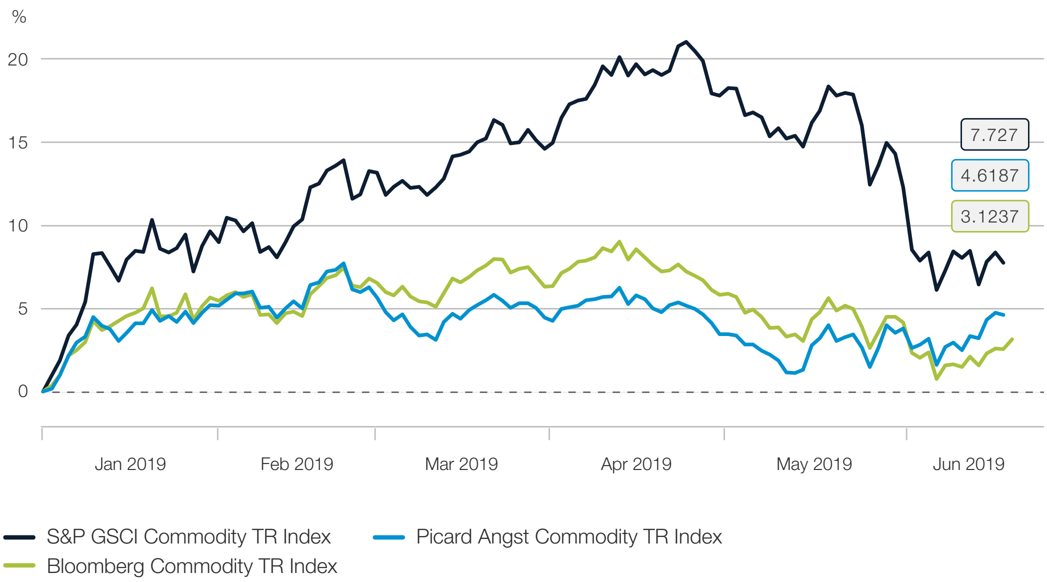
The commodity markets delivered an attractive performance over the first half of 2019. The rise was led by the cyclical sectors of energy and industrial metals. This largely offset the sharp correction suffered by the commodity markets in the previous year. The weak performance in the second half of the previous year was particularly disappointing, as the late-cyclical expansion phase of the global economy currently offers a favourable economic environment, which in the past was accompanied on average by particularly high commodity returns.

The rapid recovery that has now taken place reinforces our view that the sharp price correction should not be seen as a harbinger of the end of the commodity cycle, but merely as an intermediate correction. To a large extent, this could be attributed to exogenous factors of a political nature (US-China trade conflict, sanctions and antitrust policy in the energy sector) rather than a lack of constructive fundamental data in the individual commodity sectors.

The leading role played by the energy sector in the recovery of commodity markets favoured strategies with a pronounced cyclical profile. Accordingly, among the broad commodity benchmarks, the extremely energy-heavy S&P GSCI Commodity TR recorded by far the highest gain with a return, even though the correction of the oil price in the middle of the year significantly reduced the degree of outperformance. More balanced benchmarks such as the Bloomberg Commodity TR Index rose more moderately. Despite its comparatively less–cyclical sector profile and the initially weaker development of the agricultural sector, our in-house PACI strategy (investable via our fund product Picard Angst All Commodity Tracker Plus) managed to beat the benchmark Bloomberg Commodity TR (see Fig. 24).

Fig. 24

Picard Angst Commodity TR vs. Benchmark Indices 2019

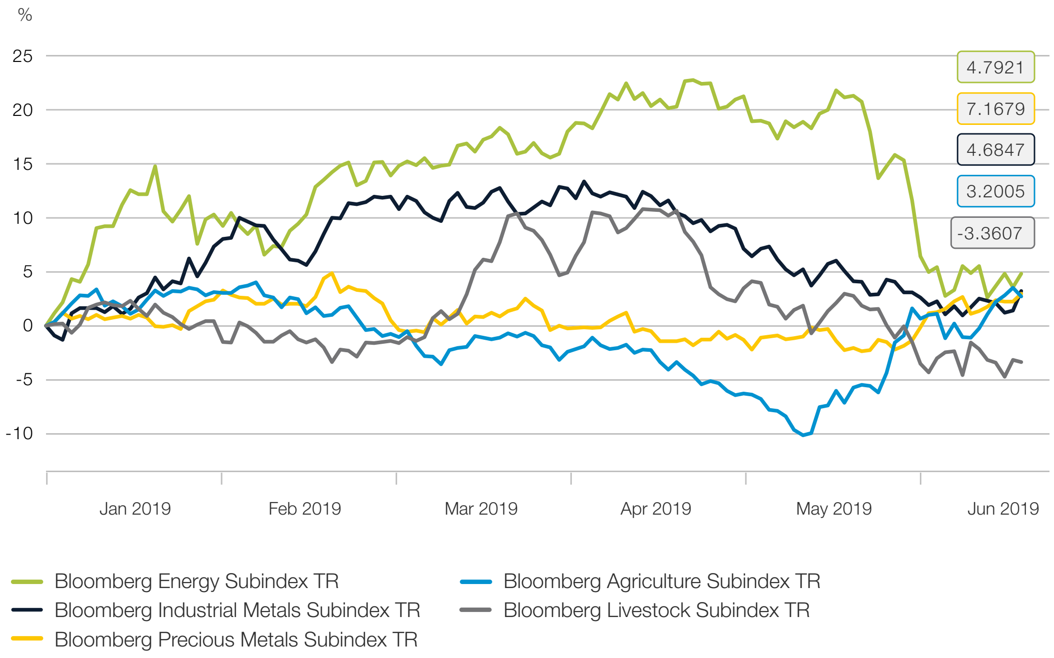


Source: Bloomberg LP, 2019

Thanks to their concentration on predominantly cyclical sectors, yields were particularly high in those strategies that did not take agricultural commodities into account. In this category, our Picard Angst Energy & Metals strategy (can be invested via our fund product Picard Angst Energy & Metals) clearly outperformed the benchmark Bloomberg Commodity ex-Ag ex-LS TR.

Fig. 25

Development of commodity sectors in 2019



Source: Bloomberg LP, 2019

4.2 Commodities

The economic risks are increasing. However, there are still strong arguments in favour of the rebound continuing on the commodity markets

In the past, commodity prices experienced the biggest appreciation and outperformed other asset classes when the economic cycle had already peaked, resource shortages were felt and central banks began to hit the brakes. In particular, the pronounced outperformance in the late cyclical expansion phase can be explained by the fact that commodity prices are determined by the supply and demand situation on the spot market – unlike financial equities such as shares, which discount future growth and cash flows. Prices thus rise when the current level of demand exceeds available supply.

Even if leading indicators indicate an increasing weakening of the global economy, the current level of activity remains robust and the global economy remains on course to expand by at least 3% in the current year. The development of commodity prices is primarily determined by the current level of activity and not by the anticipated future path of growth. As long as demand outweighs supply, positive returns can generally be expected.

The sharp correction in commodity prices at the end of the previous year created good conditions for a substantial recovery. However, uncertainty about the economic outlook has also increased significantly. This is likely to be reflected in an increasing dispersion of yield development between sectors and individual commodities over the course of the year. In particular, preference should be given to commodities that are confronted with supply-side bottlenecks or production restrictions, while demand-driven agents may have to struggle. This speaks for positive return prospects, especially for agricultural commodities but also for the oil complex. However, caution is required with base metals and natural gas. In addition, falling real interest rates and rising risk aversion point to upward potential for precious metals.

Alongside economic factors, however, the importance of favourable political conditions must not be overlooked. The intensification of the trade conflict between the United States and China has increased the political risks.

The expectations we formulated at the beginning of the year, that annual returns for our in-house commodity investment strategy would be between 10 and 15 percent, presuppose that a further escalation will be avoided and that an amicable agreement will be reached in the coming months.

In detail, the following factors in particular will likely continue to support commodity markets:

The sharp decline in capital expenditures and investments in new production capacities since the global financial crisis is increasingly becoming a limiting factor in meeting rising demand.

The majority of the most traded commodities now have declining inventory turnover rates and thus supply deficits. The reduced availability of commodities also has an impact on the maturity structure. For example, the forward curves in the energy sector have inverted significantly and flattened out for individual base metals and agricultural commodities. The roll yield profile for investors is thus materially improved.

The US Federal Reserve's leading role in the normalisation of monetary policy was reflected last year in a substantial appreciation of the US dollar on a trade-weighted basis. It is now clear, however, that the US key interest rate cycle has already passed its peak. A gradual weakening of the dollar is therefore to be expected for the rest of the year, which will have a tailwind effect on the commodity markets.

With the deterioration in sentiment towards the end of last year, investor exposure to the commodity markets has also declined significantly. Substantial capital outflows have brought the net positioning of financial investors to the lower end of the historical range. In the past, this investor positioning data has proven to be a useful counter-indicator, as extreme values have often preceded trend reversals.

The return on collateral yield has recovered noticeably over the past year by more than one percentage point and currently stands at over 2% p.a.

Over the past year, commodities in a mixed portfolio have not had the expected diversifying effect. However, should political factors recede into the background, it can be expected that they will re-establish the regime of low correlation of previous years with equities and bonds. The correlations between the individual commodity sectors continue to move towards zero.

The risks that could jeopardise our positive scenario for the commodity markets include the following:

The global slump in inflation expectations is cause for concern. On the one hand, this is a further indicator of a slowdown in the global economy and, on the other, unexpected inflation is a primary driver of commodity prices.

The escalation of the smouldering trade dispute between the United States, China and the EU into an all-out trade war could torpedo the growth of the world economy and severely affect demand for commodities. On the other hand, should the impact of new tariff barriers be limited, the resulting friction and increased production costs will tend to be reflected in rising commodity prices.

Economic momentum in China has been much more severely affected by the consequences of the trade conflict than the US economy. A significant further cooling of the Chinese economy would have far-reaching effects on the energy, metal and agricultural markets. However, China has already introduced far-reaching fiscal and monetary policy measures to stimulate the economy. Their effect should become increasingly apparent over the coming months and – if successful – keep growth above the six percent mark in 2019.

4.3 Commodities

Energy

In response to the sharp price correction in the oil complex towards the end of last year, the OPEC cartel and Russia decided to introduce new production cuts. As a result of the measures taken on the production side and sustained growth in energy demand, global oil reserves have begun to shrink again. This is also reflected in the forward curves of the benchmark oil grades, which have inverted again and thus promise positive rolling returns to investors in backwardation.

At the same time, however, production growth in the American shale oil sector continues unabated. While the additional supply in the first quarter was absorbed by robust consumer demand, US stockpiles are now rising sharply again. However, the decline in exploration activity since the beginning of the year (measured by the rig count) as well as corresponding forecasts by the EIA give hope that the growth rate of production will decline in the course of the year, especially as investors in this sector are increasingly insisting on discipline and profitability being given priority over growth.

In the meantime, however, since Brent crude oil significantly exceeded our price target of USD 70 per barrel in May, uncertainty about the fundamental condition and outlook of the global oil market has increased significantly. Factors that limit supply, such as the contamination crisis of the Russian export pipeline system and the US sanctions against Iran and Venezuela, have receded into the background and market participants have turned their attention to the gloomy outlook on the demand side of the market against the backdrop of declining economic indicators and the intensification of the US-China trade conflict.

However, the fact that the price correction of recent weeks was not accompanied by an easing of the supply situation on the physical oil market and that the inversion of the forward curves, especially at the short end, has not abated, makes a sustained correction unlikely, at least in the short term. In addition, there are many indications that OPEC and Russia will soon agree on an extension of the current production cuts until the end of the year. This should contribute to a recovery and stabilisation of price developments. However, with no signs of a turnaround in the economic outlook, a lasting return to Brent prices above USD 70 per barrel cannot be expected for H2 2019.

4.4 Commodities

Industrial metals

Many base metals are in a fundamentally encouraging condition. Sector-wide robust growth in demand contributed to a gradual reduction in inventory turnover rates on the futures exchanges. This has also increasingly been reflected in the forward curves. Alongside zinc, copper has thus turned into backwardation, and the term structure of aluminium, lead and nickel has flattened out. Production costs have also risen in various ways, for example in the case of aluminium, where the input factor of alumina has become significantly more expensive due to a shortage of supply. Nickel is increasingly becoming the focus of attention due to its potential for the production of batteries for electric vehicles. According to analyst estimates, the amount of nickel required for battery production will increase tenfold over the next eight years.

While the sector recorded a significant recovery in prices in the first quarter against this backdrop, the escalation of trade conflict in the middle of the year has already caused it to evaporate. Given the sector‘s high dependence on demand and the central role of China as the largest consumer and producer of industrial metals, a resumption of the recovery trend will require not only a solution to the political problems, but also signs that the economic outlook is stabilising.

Furthermore, it can be assumed that the prospects for the individual metals will diverge significantly in terms of their supply dynamics. The decisive factor here is whether the supply cycle is dominated by long-term or short-term factors. The medium- and long-term prospects for copper remain positive, as the slump in capital investments since 2013 has brought the supply growth phase to an end and the development of new production capacities is subject to long lead times. In contrast, the aluminium market is likely to face a headwind. The availability of raw materials and the input factor of energy is not limited. However, the supply-side reforms and new environmental requirements in China have cemented higher cost structures, which will prevent prices from falling back to 2016 levels.

The long-term prospects for base metals remain extremely positive. The mining industry is only slowly moving away from a record low in profit margins, which fell to their lowest level since 1998 in 2016. In the past, they proved to be a reliable indicator for the development of the market balance with a delay of about two years. This suggests that the sector will continue to recover in the coming years as supply deficits increase.

4.5 Commodities

Precious metals

Last year, the precious metals sector was particularly characterised by a lack of sustained demand for gold as a safe haven. The negative investor sentiment not only became extreme with regard to gold but also with regard to other monetary precious metals such as silver and platinum, meaning that the number of short positions in the futures markets for gold, i.e. bets on falling prices, reached record levels, while long positions betting on rising prices reached a multi-year low.

But extremes in investor sentiment and positioning are often harbingers of a turning point for the trend. And the mood of market participants in the precious metals sector has thus fundamentally changed compared to the previous year. The turnaround in central banks worldwide away from normalisation of monetary policy towards renewed easing has made a major contribution to this. As a result, long-term real interest rates in the dollar zone, one of the primary determinants of the gold price, have begun a sustained downward trend. This helped the gold price to break above USD 1,400 per troy ounce, which means that our price target was already reached before the middle of the year.

Over the past five years, the gold price has been trapped in a broad sideways movement between USD 1,050 and USD 1,380 per troy ounce. Now that gold has managed to break out of this range, there is a good chance that the upwards trend will continue. Factors that drove the last long-term rise in the gold price are once again coming to the fore. They include:

Robust physical demand: The demand for physical gold, traditionally dominated by China and India, is beginning to rise significantly again. Central banks are also increasingly acting as buyers again and already increased their purchases by 22% in the previous year.

Devaluation of the US dollar: Instead of further interest rate hikes, the US Federal Reserve now expects up to three rate cuts by the end of the year. At the same time, the monetary policy scope of the central banks in Europe, Great Britain and Japan is limited. This should contribute to a gradual depreciation of the dollar in the second half of the year

Increasing economic and financial market risks: Increasing concerns about the outlook for the global economy, geopolitical conflicts and stability risks in view of the historically high leverage of corporate balance sheets should sustainably increase the demand for gold to hedge portfolios.

Against this backdrop, and in view of investors' still comparatively moderate positioning, we expect gold's upward trend to continue in the second half of the year at around USD 1,500 per troy ounce.

Fig. 26

Falling real interest rates fuel rising gold prices

Source: Bloomberg LP, 2019

4.6 Commodities

Agricultural commodities

In addition to base metals, agricultural commodities have felt the effects of the ongoing trade conflict between China and the United States most severely. The result was a noticeable decline in participation in the futures markets for agricultural goods. US soya beans were hit hardest in the price formation, with China reducing a previously used export share of more than 60% to zero. However, the prices of other major US futures contracts on cereals and soft commodities such as cotton also suffered significantly. This development is particularly lamentable for financial investors, who, due to liquidity and market access requirements, are dependent on the contracts of the major US futures exchanges and are generally unable to switch to local markets that are not affected or are benefiting from the situation, for example, for soy beans in South America.

For most of the first half of the year, agricultural commodities, in particular cereals, recorded a disappointing price trend. In contrast to other asset classes, high expectations of an amicable settlement in the near future were never priced in. Similarly, latent weather risks were neglected until they began to crystallise in May. Extensive flooding in the midwestern United States has led to massive delays in sowing corn, soybeans and wheat. There are now signs of a significant reduction in acreage, which will result in a much stronger than expected reduction in inventories and a dramatic turnaround in grain prices on the futures markets, which could continue in the second half of the year.

Among soft commodities, the outlook is positive, especially for the sugar market. This is because the supply and demand balance for raw sugar is moving into an increasing deficit. The prospect of a potential return of the El Niño weather phenomenon in the third quarter, which increases production risks, is likely to increase volatility.

Your contact

Christopher Kumpas

CEO Picard Angst MEA
E-mail: christopher.kumpas@picardangst.com
T +971 (0)4 3785 111

Investments and consumption will bring growth back on track

Chrys Kamber, Fund Manager – Head of Indian Investments

In Short

· General election: Mr. Modi has returned as PM of India with a historic mandate

· US government has withdrawn the exemption granted to eight countries including India for oil imports from Iran.

· Termination of GSP program between US and India

· Three rate cuts: 75 bps cut within the first six months of 2019

· NBFC defaults and credit slump

· Slowdown in real GDP growth

Outlook

· Stable government and continuity of economic reforms

· India can benefit from US-China trade war

· Another 50 bps cut in interest rate and 25 bps cut in cash reserve ratio expected

· Private capex to start as the capacity utilization have reached the threshold

· Government spending will continue and consumption to recover in 2QFY20

· Performance gap between the large cap and mid & small cap and the stark valuation divergence should narrow

· Global indices are trading at high valuations, undervalued Indian small and mid-cap provide better alternative

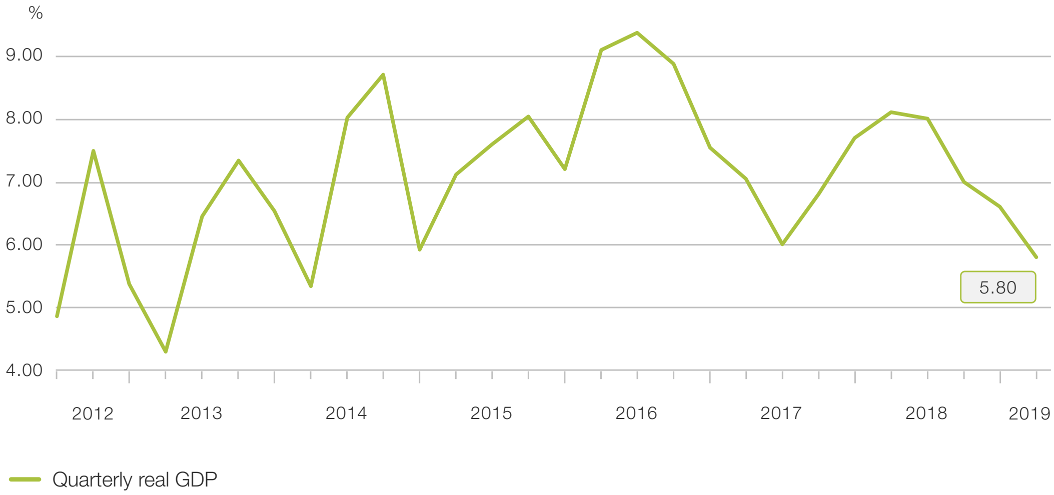
5.1 India

Weak first six months

The Indian economic data has not been encouraging for the first half of CY2019. The real GDP growth moderated to 5.8% during the fourth quarter of FY19 (January -March 2019). This was expected, given that it was an election year. However, the real GDP for the full FY2019 (April 2018 - March 2019) still grew by 6.8%.

Fig. 27

Real GDP growth



Source: Bloomberg LP, 2019

Heightened global volatility, interest rate hikes in developed economies, general election uncertainty and the valuation differential compared to other EMs shifted the global allocation from India to developed markets at the beginning of the year. Additionally, the geo-political tension between Pakistan and India and the US sanctions on Iran weighed down investor sentiment. The majority of domestic investors adopted a wait and watch mode to the political continuity is in place after the elections. They either held high levels of cash in their portfolios or found refuge in large cap strategies.

A chain of defaults in debt repayment related to promoter groups such as Reliance Communications, Vedanta and Essel Group and NBFCs such as Dewan Housing Finance Corporation, dominated the first half of the 2019. As a consequence, banks have become risk averse and are lending cautiously. Nevertheless, the NBFCs with strong balance sheets and a good track record have been able to raise funds and continued to post strong growth.

India was granted an exception to import crude oil from Iran despite US sanctions being in place. The reversal of the US stance related to such waivers and the termination of the General System of Preferences (GSP) Program by the US government triggered a negative sentiment and, hence, the broader stock market underperformed the large cap Nifty 50 Index. India was a beneficiary of the GSP program since 1974. Although this program was initially significant for India, the quantum of benefit has reduced over the years. The causalities related to the GSP termination is therefore minimal. Abandoning its usual non-confrontational stance, India has decided to retaliate on US imports.

The general slowdown in economic activities during the election year had an impact on the corporate earnings. The Q4FY19 (Jan. - Mar. 2019) earnings growth fell for the first time after posting positive earnings for six consecutive quarters. The companies in the consumer staples, discretionary and auto sectors suffered the most, due to the moderation in the overall demand. The two wheelers category saw a sharp decline due to the fall in aggregate rural demand. Auto and auto ancillary sectors sales slumped amid the tight liquidity environment, a sharp decline in demand of first-time buyers and the increase in insurance costs. The rural distress, liquidity crunch and the general election took a toll on consumption. Interactions with the management of consumer related companies suggest that the earnings will recover from the September quarter onwards.

Mr. Modi's scale of victory in the recently concluded general election put the political uncertainty to rest. On the day after the exit polls had indicated a strong win for the BJP led NDA government, the stock market opened with a gap and the Nifty 50 Index reached an all-time high at closing. Only few stocks were driving the Nifty Index while the rest of the index components and the broader market were passive spectators. The gap between the large cap versus small and mid-cap has widened further.

5.2 India

Undervalued SMEs ideally positioned

The noise around the US-China trade war, global growth slowdown and geo-political tensions will take their own course but in the Indian context, the growth has upward momentum.

Given the strong mandate of the government, there is a general expectation for major reforms such as land acquisition and labour law to support the manufacturing industry. The latest PMI manufacturing data has hit a three months high which in turn suggests the worst is over and growth recovery is around the corner.

The government has set the priority to bring the economy back to a higher trajectory, focusing on investments and tackling the unemployment rate of young Indians in order to restore consumption. The real interest rate in India is still high (+3%) compared to other major economies, which makes Indian businesses less competitive. At present, central banks globally are firmly leaning towards dovish stance. Hence, the RBI would take the same trajectory and reduce the benchmark interest rate. Benign inflation (an average of 3.5% over the last 18 months) and stable crude oil price will persuade the RBI to cut the interest rate by 50bps (25bps cut in August), along with a 25bps cash reserve ratio (CRR) cut in FY20. A nominal GDP target of USD 5 trillion and the government's initiative to issue USD denominated bonds will further incentivize RBI to prevent depreciation of the rupee. In this context, INR has sufficient room for further appreciation against the US dollar by end of this year. INR 700 bn was allocated to recapitalize the public sector banks, post which the banks will be in better shape to fund higher credit growth. Easing monetary policy and faster lending process should enable the private capex to kick start by the end of this year, as the total capacity utilization has reached 77% (historically, the private capex rebounds when the capacity utilization reaches roughly 75% - 80%). A lower cost of capital and GDP growth recovery will aid the broader equity market.

While India needs to address the domestic challenges, it sees a window of opportunity in the US-China trade war. Many US companies are diversifying their China dependent portfolio and looking for relocation. India can provide the basic ingredients to attract these businesses such as a skilled labour force at low cost and tax incentives. The country has improved the ease of doing business in the last five years, and combined with a stable government and common law based judicial system provides additional support for this case. We are seeing a similar trend developing in the Indian chemical industry since a couple of years, initiated by stringent Chinese anti-pollution norms and security compliance, which are already in place in India. The technology and industrials sectors will be the next major beneficiaries. This influx will create employment, boost exports and accelerate the economic growth.

During its first mandate, the Modi government, through different schemes, built 218'000 km of roads (triple the size of the total road network of Switzerland), established 112 million LPG connections, built 15.5 million affordable housing, 92 million toilets and has provided 40 million households with electricity in rural India. These schemes had secured the rural votes despite the hardship caused by the demonetisation and the GST implementation.

Furthermore, in the FY20 post-election budget, the government has increased the allocation to the agriculture sector and to the farmers' welfare schemes by 92.5% in order to double the farmers' income in the next five years. The direct benefit transfer (DBT) system will ensure that these benefits will reach the farmers directly without any leakages. The improvement in rural infrastructure and rural schemes should boost the rural economy and support the recovery of the rural consumption by the end of this year, which is in line with the narrative of the management of consumer sector companies.

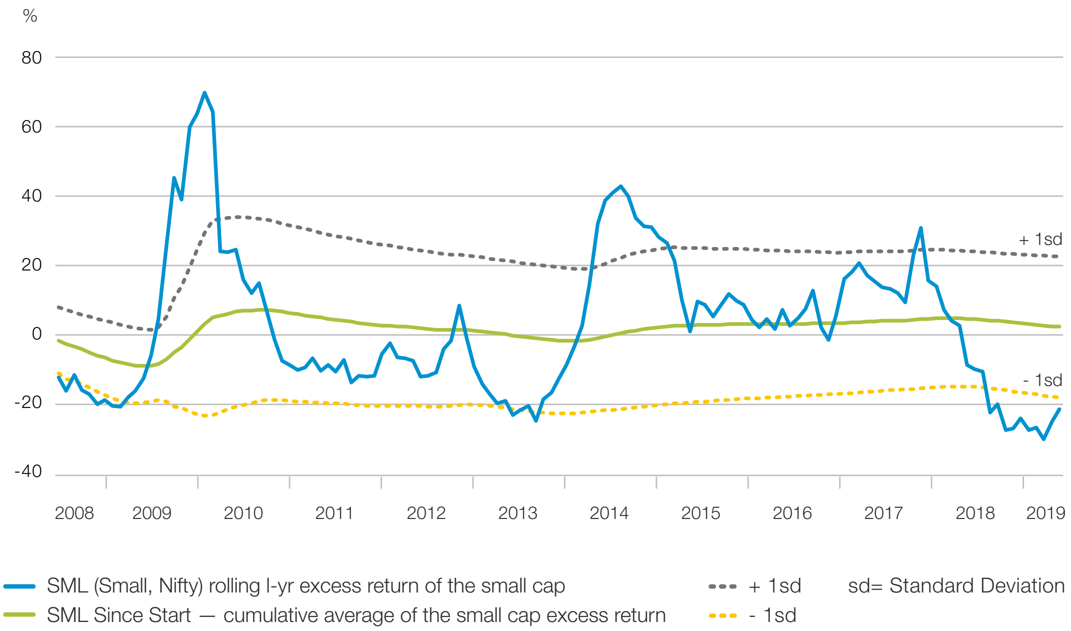
The FY20 post-election budget has paved the way towards a reduction of the fiscal deficit to 3.3% (instead of 3.4%), while taking measures to facilitate foreign capital inflows. Disinvestments in some of the public sector undertaking to the amount of INR 1 trillion is in the FY20 agenda of the government, which should accommodate the government spending in infrastructure. Other key announcements of the budget were a 14% increase related to the infrastructure spending. Public spending, which took a back seat during the election, will now be resuscitated. Paused infrastructure projects will get a fresh start and new infrastructure projects will be rapidly approved. Companies in building material, construction and equipment manufacturing should benefit.

A stable government ensuring continuity of policy reforms has encouraged the foreign investors. International sovereign wealth funds are investing in Indian infrastructure from renewable energy to airports. Private equity deals have surged, in 2018 roughly USD 19 billion was invested in private equity deals, the highest in the last ten years. This trend will continue and India will be among the top countries receiving FDI inflows.

The current macro factors are supportive of an earnings revival: low inflation, falling crude oil prices, easing monetary policy and a narrowing current account deficit. Moreover, our interactions with the managements of consumer credit companies suggests that a full revival in consumption is expected in the 3QFY20 (October - December 2019). The FY20 budget has reduced the corporate tax to 25% for companies generating revenues up to INR 4 billion, which is another booster for smaller enterprises.

Fig. 28

Small-cap positive cycle is imminent



Source: Picard Angst - Bloomberg LP. 2019

Finally, the performance gap between the large cap and mid & small cap and the stark valuation divergence should narrow. The Nifty 50 Index is trading at two standard deviation above the mean and the small cap index is around one standard deviation below the mean. The performance of the Nifty 50 Index since 2018, was driven only by top ten companies. The top weighted companies generated a performance of 30% while the rest of the Nifty 50 companies posted a negative return of 13%. In combination of rate cuts, moderation in cost of capital and GDP growth recovery will support the earnings growth. Small and mid-sized companies with healthy balance sheets, stronger earnings outlook and gaining market share in domestic consumer related businesses will outperform by the end of this year. However, a broad-based earnings recovery might take another two quarters until the monetary policy and other growth supportive measure are fully transferred into the system. As the valuations are all time high globally, Indian small and mid-cap are in the sweet spot in valuation perspective.

Your contact

Christopher Kumpas

CEO Picard Angst MEA
E-mail: christopher.kumpas@picardangst.com
T +971 (0)4 3785 111

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Picard Angst MEA Limited

Emirates Financial Towers, South Tower, Office 2008,
DIFC, Dubai, U.A.E. PO Box 506935
Telephone: +971 (0) 43785111
info@picardangst.com, www.picardangst.ae